

Greenspan Stands His Ground

By Steven Mufson
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Perhaps the Maestro composed some discordant notes after all.

The record of longtime Federal Reserve chairman Alan Greenspan -- worshipped by business leaders and dubbed "Maestro" in a 2000 biography by The Post's Bob Woodward -- is getting a critical look as his successor Ben S. Bernanke wrestles with problems that began on the Maestro's watch.

Many economists blame Greenspan for lax bank supervision and for keeping interest rates too low, too long from mid-2003 to mid-2004. That, the theory goes, fueled the housing bubble and spawned subprime and adjustable-rate mortgages for low-income people, vast numbers of whom can't make their payments now. Banks bought those mortgages in bundles that are worth far less than they originally were. That has led to big write-offs, shaking the entire financial system.

In an interview yesterday, Greenspan said the Fed wasn't to blame. He said that global forces beyond the control of the Federal Reserve had kept long-term interest rates low, fueling the housing bubble earlier this decade. "Those who argue that you can incrementally increase interest rates to defuse bubbles ought to try it some time," he said. "I don't know of a single example of when interest rate policy has been successful in suppressing gains in asset prices."

Regarding the current turmoil, Greenspan said that a market crisis was inevitable. "If it weren't the subprime crisis it would have been something else," he said. That is because an era was ending that had seen "disinflationary forces" from developing countries such as China and a "protracted period" in which there was an "underpricing of risk."

Not all economists are ready to let the former Fed chairman off so easily.

Lee Hoskins, former president of the Cleveland Fed and Fed chairman from 1987 to 1991, says that to find "partial causes" of the credit turmoil, "you have to go back to the Fed's decision to push the federal funds rate down to 1 percent and leave it there for over a year." Hoskins says the Fed "made money very cheap, and we began to see the whole leveraging process we see today. The Fed has to take responsibility for some of that excessive growth."

Greenspan says that the Fed was worried about "corrosive deflation" at the time and that he saw that as a greater threat to the U.S. economy than a housing bubble. "There was a real serious concern about deflation," he said yesterday. "If you look at the notes of the Open Market Committee, the pressures were to go lower than 1 percent. There were no dissents." Bernanke, a member of the Fed board at the time, was also concerned about deflation.

Greenspan also argues that while the Fed has a lot of power over short-term rates, it has less influence over long-term rates, which he asserted were more important to housing prices. Even after the Fed starting raising short-term rates, long-term rates did not rise. He said that at the time "it became apparent that we lost control" of long-term interest rates "as did the Bank of England and all the central banks. As a consequence, we had very little ability to put a brake on the rise in home prices."

But other economists say that the very low short-term rates made adjustable-rate subprime mortgages, those with the worst default rates, more attractive than they otherwise would have been. Hoskins also argues that low short-term rates fed excesses at investment banks, which relied heavily on overnight financing while lending long term. "I don't know what Bear Stearns was banking on. I guess that nothing bad would happen -- ever," Hoskins says.

Others reviewing the Greenspan era at the Fed say there is a difference between the way Greenspan reacted during sharp sell-offs of stocks and the way he reacted to the technology and housing bubbles.

Kenneth Rogoff, a Harvard economics professor and former chief economist at the International Monetary Fund, says that "the important point . . . is the philosophy of monetary policy that says 'you don't pay attention to asset prices when they are rising, only when they are falling.' " In reality, Rogoff adds, "if you cut interest rates when asset prices are in free fall, then when asset prices are rising while indebtedness is rising all over country, you need to raise rates. He actively chose not to do that."

Other economists fault Greenspan for his failure to closely regulate big banks. Alan Blinder, a Princeton University economics professor who was vice chairman of the Fed under Greenspan in the mid-1990s, says that the delay in raising rates in 2003-04 was a "minor blemish" on Greenspan's "stellar" record managing monetary policy. But Blinder says that he would give the former chairman "poor marks" for bank supervision, another key role of the Fed.

Blinder said that Greenspan "brushed off" warnings -- most notably from fellow Fed governor Ned Gramlich -- about mortgage abuses and dangers.

"Lending standards were being horribly relaxed, and the Fed should have done something about that, not to mention about deceptive and in some cases fraudulent practices," Blinder said. "This was a corner of the credit markets that was allowed to go crazy. It was populated by a lot of people with minimal financial literacy who were being sold bills of goods by mortgage salesmen."

Gramlich, who died last fall, proposed that the Fed send examiners into the consumer lending offices of Fed-regulated bank holding companies, which he said originated about 30 percent of subprime loans. In a speech last Aug. 31, Gramlich said "this whole subprime experience has demonstrated that taking rates down could have some real costs, in terms of encouraging excessive subprime borrowing." Moreover, he added, there was "a giant hole in the supervisory safety net. . . . It is like a city with a murder law but no cops on the beat."

Greenspan said that most of the subprime mortgages were originated by firms regulated by other agencies, but he adds, "In retrospect it was clearly a mistake" not to examine bank lending more closely. He said it was "very late in the game [that] we realized the size of the problem." He said that Gramlich had written him a note shortly before he died saying that if he had been more convinced, he would have pressed harder for action after Greenspan expressed doubts.

Greenspan has also been widely criticized for comments he made on Feb. 23, 2004, in which he encouraged homeowners to take out adjustable-rate mortgages, or ARMs. In a speech to the Credit Union National Association, Greenspan said that a Fed study showed that many homeowners would have saved tens of thousands of dollars over the previous decade if they had taken ARMs.

In fact, if homeowners had converted from ARMs to 30-year fixed-rate mortgages at that time, they might have avoided the repayment problems some people are now experiencing.

Greenspan said yesterday that he tried to correct those comments on March 2, 2004, less than a month later, in a New York speech praising 30-year fixed mortgages. "If I am guilty of encouraging people to take out adjustable-rate mortgages, I am guilty for 30 days," he said.

In his memoir, "The Age of Turbulence," published last year, Greenspan made scant mention of the time bombs that were planted when he was still chairman.

"I was aware that the loosening of mortgage credit terms for subprime borrowers increased financial risk, and that subsidized home ownership initiatives distort market outcomes," Greenspan wrote.

But the former Fed chairman said that the subprime boom would boost home ownership and was "worth the risk." Greenspan said that "protection of property rights, so critical to a market economy, requires a critical mass of owners to sustain political support."

Although home ownership rose from about 64 percent to 69 percent from the early 1990s through the middle of this decade, many analysts say that they doubt that had much effect on U.S. popular support for a market economy.

Regarding the mounting levels of debt, encouraged in part by the low cost of borrowing, Greenspan said that he was "reluctant to underestimate the ability of most households and companies to manage their financial affairs."

Greenspan compared bankers immediately after the Civil War, who he said sought to back two-fifths of their assets with equity, to today's bankers, who "are comfortable with a tenth." Yet, he said, bankruptcy is less prevalent today than it was 140 years ago.

"Rising leverage appears to be the result of massive improvements in technology and infrastructure, not significantly more risk-inclined humans," he wrote. Quoting two 1956 articles in Fortune magazine, alarmed by rising consumer short-term debt and mortgages, Greenspan noted that the magazine's grim forecasts did not come true. Economists worried that the ratio of

household debt to household income was so high that it threatened families with delinquency and default, but, Greenspan said, assets and household net worth were rising faster than they knew.

"I do not recall a decade free of surges in angst about the mounting debt of households and businesses," he wrote. "Such fears ignore a fundamental fact of modern life: in a market economy, rising debt goes hand in hand with progress."

Blinder says: "It was not that Americans have too much credit card debt, which they do, or . . . that corporations are overleveraged, which they're probably not. It's not even that the typical American householder has a mortgage that's too big. But in that corner of the [mortgage] market, which turned out to be not such a small corner, a lot of bad practices were going on."